Cash pool: transfer pricing aspects (3) 1/44/19


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To complete our series of articles on the transfer pricing (TP) aspects of a cash pool, this article explores what data and sources are used in practice for setting fees (interest rates) for cash pool members depositing and borrowing cash.

Interest rates to be charged in cash pool transactions

The State Revenue Service (SRS) has yet to express an official opinion on what comparables should be used to set fees for cash pool members. However, the SRS litigation over cash pool transactions leads to the conclusion that they are treating both a deposit and a loan as loan transactions. Accordingly, to find arm's length interest rates on cash pool transactions, we need to look for comparable loans, not deposits.

When it comes to identifying internal or external comparable loan transactions, the Comparable Uncontrolled Price method is recognised as appropriate for most financing (including cash pool) transactions. Yet the risk remains that this method might not be used without sufficient comparability of transactions affected by a number of factors. For example, according to the OECD Base Erosion and Profit Shifting (BEPS) discussion draft published in July 2018, in assessing comparability of transactions, we should consider various price drivers, such as the borrower's line of business, the purpose and term of the loan, the type of payment (fixed or variable), the frequency of payments, any collateral and credit support (a guarantee), the amount and currency of the loan, and any other related transactions and market differences the SRS will examine as part of their control processes.

Internal comparablse

Multinational cash pool members often face situations where a taxpayer's comparable loan transactions with third parties can be identified, i.e. internal comparables that can be used to prove that the interest rates charged on a loan from the cash pool meet the arm's length standard. Yet it is important to make sure that such internal data is reliable and comparable for analysing a cash pool transaction by assessing whether key economic conditions (such as the date, term and amount of the loan, as well as the functions and risks of the parties) are similar enough.

External comparables

A company that has no internal comparables to use for analysing its cash pool transactions should look for alternatives, i.e. external comparables such as interest rates published by the Bank of Latvia (BOL) or comparables offered by specialist databases.

BOL interest rate statistics

The BOL publishes monthly statistics on weighted average interest rates charged in transactions between (Latvian) resident non-financial entities and financial institutions.[1] Although the SRS has said unofficially that BOL interest rate statistics cannot be used for TP purposes, there is no alternative other than drawing comparables from specialist databases. So in practice BOL rates still serve as a good indicator for estimating risks where it is not possible to search a specialist database such as Bloomberg for certain reasons.

BOL interest rate statistics are grouped according to various criteria (such as the amount and term, any collateral) but since those are weighted average rates, it is not possible to find rates charged on certain transactions nor key price drivers such as the borrower's credit rating and the purpose of the loan.

Using BOL statistics gives us mainly two ways of finding a comparable arm's length interest rate:

1. The last published rate available at the time of the transaction;
2. A range of rates available at the time of the transaction (e.g. over the last 12 months).

In practice, we have seen both approaches taken by taxpayers and the SRS.

Sourcing comparables from specialist databases

If transactions are sufficiently material in size, it is advisable to prepare a benchmarking study using specialist databases that offer details of financial transactions between unrelated parties, such as the Bloomberg database. This makes it possible to conduct a benchmarking study based on a number of comparability criteria, including the borrower's credit rating (which is the main comparability criterion in financial transactions), the purpose of the loan, and many other criteria. If the company holds such comparables and has prepared appropriate TP documentation, the SRS will find it far more difficult to challenge prices applied in the company's transactions.

As stated above, in a TP analysis of cash pool transactions, it is important to analyse the functions and risks of the parties, the subject matter of the transaction, and other price drivers, then choose appropriate comparables for analysing the arm's length price of the controlled transaction according to those findings and the taxpayer's desired level of comfort.

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[1] Table 21. Weighted average interest rates charged by MFIs in transactions with resident non-financial corporations and households